Petition

81-786

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NO._____

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1981

NATHANIEL BRAMS
AND
EIREEN BRAMS,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE CIRCUIT
COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITION

Bernard A. Kansky, Esquire
131 State Street, Suite 201
Boston, Massachusetts 02109-3280
(617) 227-2020
Counsel for Petitioners

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QUESTIONS PRESENTED

The Petitioners, as taxpayers filing a joint income tax return for the year 1973, were assessed a tax deficiency of $27,499.50 by reason of reporting as capital gain, proceeds received by the Petitioner, Nathaniel Brams, pursuant to an alleged covenant-not-to compete contained in a Purchase and Sale Agreement for corporate assets of a corporation wholly owned by him. The amount was reported as a capital gain, upon advice of counsel after reviewing the then new decision of Dixie Finance Co., Inc. v. United States of America et als 474 F2 501, 504-505, including in said return, a statement of full disclosure for so reporting. The theory relied upon by Petitioners and counsel was based upon a parallel fact pattern which indicated the Petitioner's covenant not-to-compete lacked economic reality.

Additionally, the remarks and conduct of the Trial Court in this matter during the course of trial directed to the Petitioners, their witnesses and counsel were sufficiently severe so

as to have evoked comment by the Circuit Court of Appeals for the First Circuit to the effect that,

> "...the conduct of the tax court judge, while at points overzealous and even sarcastic (emphasis added by undersigned counsel) did not prejudice appellant."

The questions thereby arising are as follows:

1. What uniform standard of proof or test should be applied to determine whether a particular covenant not-to-compete is valid and enforceable and whether or not the proceeds derived pursuant thereto, should be accorded either ordinary income or capital gain treatment, inasmuch as the standards of proof and tests for same appear to vary from jurisdiction to jurisdiction, varying from the strong-proof test, to the lack of economic reality test, to the mistake, undue influence, fraud and/or duress test.

2. Is it proper for the Commissioner of Internal Revenue to take inconsistent positions on the same set of facts by evaluating a corporation at one figure for estate tax purposes

and evaluating the same corporation at another figure in determining whether or not a covenant-not-to compete has any independent economic validity.

3. If it can be accepted as undisputed that this case fits four square with the four essential elements described in the Dixie Finance decision, supra, in which it was determined that the covenant-not-to compete was invalid because it lacked economic reality, is there any valid reason why a decision should not likewise be rendered in favor of the Petitioners, especially when in 1973 they treated the proceeds as capital gain in reliance upon the 1973 Dixie Finance decision, supra.

4. Whether or not, if a Judge conducts a trial in his courtroom in a manner which the Circuit Court for the First Circuit described as overzealous and on occasion, sarcastic, and if this could reasonably be inferred to intimidate witnesses and unreasonably interfere with counsel for the Petitioners' attempt at an orderly presentation of evidence, there results a

denial of due process pursuant to the Constitution of the United States, Amendment XIV, Section 1, which can only be corrected by a reversal of the existing decision and a new trial.

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The opinion of the Circuit Court of Appeals appears at Appendix A. The opinion of the United States Tax Court is reported in T.C. Memo 1980-584. See Appendix B, Infra, pp. 678-682.

JURISDICTION

The order or judgment of the Circuit Court of Appeals for the First Circuit was entered on July 1, 1981. The Petitioners filed an application for rehearing along with a request for an opportunity to argue the matter orally, both of which were denied on or about August 19, 1981. This Petition for Certiorari was filed less than ninety days from the date as aforesaid. In addition, a Notice and Claim of Appeal had been filed within ten days of the order or judgment of the Circuit Court of Appeals. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3). A rehearing was requested on or about July 10, 1981, and denied on or about August 19, 1981.

CONSTITUTIONAL PROVISIONS INVOLVED

Constitution of the United States, Amendment

XIV, S1:

> "...nor shall any person be deprived of life, liberty or property without due process of law. ..."

STATEMENT OF THE CASE

The facts relevant to the questions presented by this Petition are substantially uncontroverted (except perhaps the issue of whether or not the Petitioner, Nathaniel Brams, was capable of competing, although it also is uncontroverted that he never did compete with the purchaser during the term of the alleged covenant, nor after its expiration, and furthermore, shortly after the sale of the corporate assets, the Petitioner, Nathaniel Brams, qualified for, received and to this day continues to receive Social Security Disability benefits by reason of his suffering from a severe heart condition).

In October 1968, the Petitioner as the sole shareholder of Salad House, Inc., a food manufacturing concern which he had founded in 1955, entered into a Purchase and Sale Agreement for the sale of all of its assets for a total

purchase price of $360,000. Prior negotiations had revolved around the proposed purchase price of $300,000.-$330,000. without any allocation for any covenant-not-to compete. After the sale price had been negotiated another $30,000. to a new total of $360,000. and after same had been accepted by the Petitioner, who was then suffering severe and painful physical ailments, and shortness of breath (later diagnosed as a severe heart condition), the Petitioner's believed-to-be trusted attorney, and his believed-to-be-trusted bookkeeper, arranged an arbitrary allocation of $150,000. or 42% of the $360,000. sale price to be allocated to an alleged ten-year covenant-not-to compete to be paid over said ten-year period. During the last most recent year the Petitioner, Nathaniel Brams, operated his corporation, the corporation showed earnings of $90,000.± per year. Shortly after the conclusion of the deal, both his believed-to-be trusted attorney and his believed-to-be trusted bookkeeper, began representing the purchaser, and in 1973 caused the

purchaser to pay off in said year in one payment the full amount of the balance then due, i.e. to wit, $90,000.[1/]

At or about the same time in 1973, the Dixie Finance decision, supra, was reported. A review of that decision suggested that the lump sum payment unexpectedly received in advance, in the year 1973, was made pursuant to a covenant-not-to compete, which according to the elements set forth in the said Dixie Finance decision, supra, suggested the covenant lacked economic reality. As a result, and upon advice of counsel, with full disclosure to the Internal Revenue Service, the Petitioner reported the proceeds received in 1973 as capital gain. The Commissioner subsequently made an assessment, initially against both the purchaser and the seller-Petitioner, and the Petitioner brought this matter for determination before the United States Tax Court.

[1/] (Plus 2 monthly payments of $1,250.00 each.)

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No: 81-1052

NATHANIEL BRAMS, ET AL.,
Petitioners, Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent, Appellee.

BEFORE CAMPBELL,
BOWNES AND BREYER, Circuit Judges.

NOTICE AND CLAIM OF APPEAL

Now come the Petitioners-Appellants in the above-captioned matter and being aggrieved by the Order of Court entered July 1, 1981, before Campbell, Bownes and Breyer, Circuit Judges presiding, affirming the decision of the United States Tax Court, do hereby claim an appeal to the Supreme Court of the United States.

The Petitioners-Appellants
By their attorney,

/s/
BERNARD A. KANSKY
131 State Street
Boston, Massachusetts 02109
(617) 227-2020
July 10, 1981

CERTIFICATE OF SERVICE

Suffolk:ss Boston, Massachusetts
July 10, 1981

I, Bernard A. Kansky, attorney for the Petitioners-Appellants, Nathaniel Brams and Eireen Brams, hereby certify that I have this date served a copy of the aforestated Notice and Claim of Appeal, by mailing a copy of same, postage prepaid, directed to John F. Murray, Acting Assistant Attorney General, Tax Division, Department of Justice, Washington, D. C. 20530; and Anthony Ilardi, Esquire, Internal Revenue Service, Washington, D. C. 20224.

/s/
BERNARD A. KANSKY

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

NATHANIEL BRAMS and EIREEN BRAMS,)
Petitioners/Appellants)
)
vs.)No. 81-1052
)
COMMISSIONER OF INTERNAL REVENUE,)
Respondent/Appellee)

PETITIONERS/APPELLANTS' MOTION TO REHEAR

Now come the Petitioners-Appellants in the above-captioned matter and respectfully request a rehearing and an opportunity to argue orally on their Brief and Record Appendix previously filed with the United States Court of Appeals for the First Circuit.

The Petitioners-Appellants,
By their attorney,

/s/
BERNARD A. KANSKY
131 State Street
Boston, Massachusetts 02109
(617) 227-2020
July 10, 1981

CERTIFICATE OF SERVICE

Suffolk:ss Boston, Massachusetts
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and Claim of Appeal, by mailing a copy of same, postage prepaid, directed to John F. Murray, Acting Assistant Attorney General, Tax Division, Department of Justice, Washington, D. C. 20530; and Anthony Ilardi, Esquire, Internal Revenue Service, Washington, D. C. 20224.

/s/
BERNARD A. KANSKY

FEDERAL JURISDICTION

Based upon existing procedure, the Tax Court where this matter was heard on the merits does have jurisdiction in these matters in the first instance. See I.R.C. § 7442, As Amended.

REASONS FOR GRANTING THE WRIT

1. The standards being applied in determining whether or not a party to an agreement involving the sale of a business should be bound by an allocation made in the agreement of sale, to a covenant-not-to compete, are so diverse that the standards vary from jurisdiction to jurisdiction, occasionally overlapping in some aspects, and at other times rising to such different standards, oftentimes within the same jurisdiction, that taxpayers and their counsel are deprived of the benefit of some uniform and standard guideline by which they may properly weigh the merits of their respective cases. By way of example, it appears that in the Danielson case, 378 F2 771, 775 (3rd Cir. 1967), the test as to invalidity of a covenant-not-to compete is based upon proving "mistake, undue influence,

fraud, duress, etc.," while as of late, in the Sonnleitner v. Commissioner decision 598 F2 464, 467, (5th Cir. 1979), the test was stated to be the "strong proof" standard. The "strong proof" rule has been the subject of divergent views among the Courts in respect of whether it rests on the intention of the parties, "economic reality," or a combination of both. See Lozinsky v. Commissioner 72 T.C. 495, 501-502.

In the 1973 decision of Dixie Finance Co., Inc. v. U.S. 474 F2 501, 505 (5th Cir. 1973), the Court applied strictly the "economic reality" test. Also on occasion, the "strong proof" test has been used interchangeably with "economic reality" test, and on other occasions such as in this instance, the Court held the Petitioners to a higher standard by requiring proof of the "economic reality" test by "strong proof" as opposed to a more uniform standard, such as is customary in civil matters, i.e. to wit, by a "preponderance of the evidence."

The net result is that the lack of clearly

defined standards, combined with erratic application of the varying standards,--varying, depending upon when a case is reached as well as the fortune or misfortune of where the Petitioner may reside, have had the effect of spawning litigation and of serving not only to confuse the taxpayers and their counsel, but also to make it extremely difficult for counsel to assess with some reasonable degree of accuracy the likelihood of success of a particular matter involving a covenant-not-to compete and thereby properly advise the client. Perhaps this existing choatic condition, in the words of Tannenwald, J.,

> "...has resulted in a long line of cases involving the tax consequences of covenants not to compete, ..." infra, p.23.

More stability and less litigation would likely ensue if the issue was resolved by this Court.

2. The questions presented before this Court are of the utmost significance, especially to the small businessmen, and is of great importance in and to the orderly administration of our federal tax laws.

The Petitioner, Nathaniel Brams, here, as a small businessman, in fact is an example of many small businessmen who by reason of ill health, age or choice decide to sell their small family-run type corporation or business entity. The concerns surrounding the sale of the family business initially relate more to finding a buyer who is willing to pay a fair price for the business and after the expenses of closing, the seller is hopefully left with enough money to maintain some dignity and some measure of his former life style. All too often, however, it is the small businessman in just such a position, who learns too late that what he counted on having left from the sale of his business, after paying his attorney and other expenses of the sale, are severely inadequate, when unexpectedly he must face an ordinary income tax on what to him must appear to be a disproportionate amount of the proceeds from the sale of his business.

3. Both the United States Court and the Circuit

Court of Appeals for the First Circuit appear to have by-passed the case law in force and effect at the time the decision was made by the Petitioner, Nathaniel Brams, to treat the unexpected lump sum payment in 1973 as capital gain based upon the case law and decision rendered in 1973 in the Dixie Finance case, supra. In reviewing the four elements set forth in the decision, indicating when a covenant-not-to compete lacks economic reality or when it satisfies economic reality, it would and did appear to counsel for the Petitioners that the facts of the Petitioners' situation fit "four square," within the guidelines clearly established in that decision, and it was upon that basis that the recommendation was made for the Petitioner to proceed as he did. Since that time, decisions subsequently have been rendered which appear in some instances do vary from Dixie Finance, supra and inasmuch as Petitioners and counsel's combined decision to treat the proceeds received in 1973 as capital gain in the 1973 income tax return, based upon a 1973

decision, taxpayers, it appears should be able to conduct their transactions in accordance with the most recent interpretations which existed at the time the taxpayer's decision to act must be made. To expect that the Petitioner or taxpayer, or his counsel would have the foresight to know what the position of the Courts might be some five to six years hence, when the matter is ultimately reached for hearing on the merits, is unrealistic. As a result, in this case an initial $27,499.50 deficiency, by reason of constantly accruing interest has now increased to in excess of $42,000. in its present posture. In the orderly administration of our federal tax laws, it would seem that the taxpayer and counsel should be able to rely upon the tax laws as interpreted at the time the decision to act must be made, and not at some unknown time in the future, whenever the matter may, by happenstance, be reached for trial. Interpretation and guidance is required by this Court, so that taxpayers, their counsel, the Commissioner of Internal Revenue and trial

justices can know which interpretation of law to apply, i.e., the law as interpreted when the income tax return was filed, or the law as interpreted from time to time, and place to place, the outcome of any case depending upon when and where it is reached for trial, as much as upon the actual facts of each such case.

4. In the conduct of any nonjury trial, it is well recognized that the trial judge has substantial leeway and discretion, especially as to the tenor of the trial and remarks both to witnesses and counsel, alike. However, it would appear that in nonjury cases, the Appeals Courts, as evidenced by this case, do not give sufficient weight to the probability that most lay parties and witnesses are strangers to the arena known as the courtroom, and being in such awesome surroundings, easily can be intimidated by a judge who continuously acts overzealously and makes sarcastic remarks. It is in this manner, that the courtroom, instead of being a forum for the orderly presentation of evidence and the judicious determination of property and

other rights, serves only to intimidate parties and witnesses, to make to some extent, a mockery of and undermine our judicial system, by interfering with counsel's attempt at putting forth, in orderly fashion, the admissible evidence upon which the Court can and should base its decision.

The judge who is overzealous and makes sarcastic remarks oftentimes makes already nervous lay witnesses and lay parties even more nervous and forgetful, and can so interfere with counsel's trend of thought and planned presentation, to the point of utter disruption and frustration. In turn, by such conduct, the Court has chilled the rights of the parties and has deprived the losing party of his right to due process. Such a judge can never know whether he has received all the admissible facts upon which to apply the law, when by his own deliberate lack of judicious behaviour he has served to stifle the presentation of all admissible facts and undermine the foundations of our judicial system. See Adams v. Yellow Cab Corporation (Mass. App. Ct. Adv. Sh. /1981/ 1585).

Our system has gone unchecked too long if the judicial system can sanction such unjudicious conduct. Sarcasm has no place in the courtroom, and if there is no sanction for the litigants who are the targets of judicial sarcasm, then the rights of other litigants will also be chilled and stifled and the respect for our judiciary, and our entire Court systems, can do no more than erode. It is essential that every litigant be entitled to and afforded a hearing and/or trial free from unnecessarily overzealous judicial conduct; free from sarcastic judicial comment; and free from disorderly and uncalled for conduct, if due process is to have any chance for survival.

It would, therefore, seem appropriate for this Court to reverse and/or at least review the orders and judgments of the United States Tax Court and the Circuit Court of Appeal for the First Circuit in this matter, while simultaneously clarifying and standardizing the degree of proof required to nullify a covenant-not-to compete; it would seem appropriate for

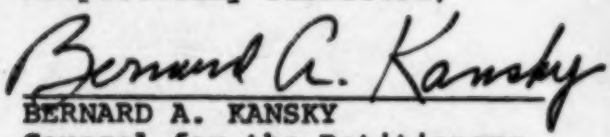
this Court to indicate to members of the bar and the judiciary whether the interpretation of the tax law to a particular set of facts is to be based upon the interpretation prevailing at the time the tax return is filed or the act accomplished, or whether the interpretation is to be the one prevailing at the time the case is reached for trial and decided.

Finally, and perhaps of greatest importance, this Court should set forth some guidelines to be adhered to by members of the judiciary to prohibit the infringement of constitutional rights by judicial conduct which is unnecessarily overzealous, or sarcastic, or in any other way lends itself to even the appearance of impropriety and the deprivation of due process.

CONCLUSION

For these reasons, a Writ of Certiorari should issue to review the judgment. and order of the Circuit Court of Appeals for the First Circuit as well as the judgment and order of the United States Tax Court, if appropriate.

Respectfully submitted,



BERNARD A. KANSKY
Counsel for the Petitioners
131 State Street
Boston, Massachusetts 02109
(617) 227-2020

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

No. 81-1052

NATHANIEL BRAMS, ET AL.,
Petitioners, Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent, Appellee.

BEFORE CAMPBELL,
BOWNES AND BREYER, Circuit Judges.

ORDER OF COURT

Entered July 1, 1981

This case fits squarely within our decision in Harvey Radio Laboratories v. C.I.R., 470 F.2d 118 (1st Cir. 1972). The conduct of the tax court judge, while at points overzealous and even sarcastic, did not prejudice appellant. The relevant facts were clearly brought out and the law properly applied.

This case is affirmed. 1st Cir. Rule 12.

By the Court:

/s/ Dana H. Gallup

Clerk.

(cc: Messrs. Kansky and Murray.)

APPENDIX B
MEMORANDUM FINDINGS OF FACT AND OPINION

TANNENWALD, Judge: Respondent determined a deficiency of $27,499.50 in petitioners' 1973 income tax. The sole issue to be decided is the proportion of proceeds received by petitioners upon the sale of their family business which is properly allocable to a covenant not to compete.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioners were married and resided in Fort Lauderdale, Florida, when they filed their petition in this case. They filed a joint Federal income tax return for the year in question with the Internal Revenue Service Center at Andover, Massachusetts.

Nathaniel Brams (hereinafter Mr. Brams) founded Salad House, Inc. (hereinafter Salad House) some 25 years ago and was its sole shareholder until he sold it in 1968. Mr. Brams worked long hours and extended weeks building Salad House into a successful manufacturer of

commercial salads and, with the help of his wife and son, his company prospered. By 1967, its net earnings were approximately $90,000 per year.

Much of Salad House's success was due to Mr. Brams' ability to adapt standard commercial food processing machinery to his company's specific needs. He improved efficiency without sacrificing quality, and thus Salad House could produce salad faster than its competitors. In addition, Mr. Brams oversaw all aspects of the business from manufacturing to distribution, and was responsible for all major decisions.

Eireen Brams (hereinafter Mrs. Brams) was an employee of Salad House from its inception. After the early years, she did much of the selling and public relations work of the business. She developed personal contacts with many of Salad House's customers. She was not responsible for developing any of the efficiency improvements, although she acquired working knowledge of the techniques created by her husband.

Petitioner's son, Robert Brams (hereinafter Robert), worked at Salad House on a part-time basis from the age of 9 until he finished his second year of college at age 20. He then became a full-time employee of Salad House and acquired broad familiarity with the total business operations. At some time after the sale of Salad House, Robert opened a commercial bakery named Best Maid, Inc.

Milton Popkin (hereinafter Popkin) has been a Salad House employee since the late fifties. He began as the bookkeeper, and was delegated substantial managerial responsibility by Mr. Brams beginning in late 1967. Between that time and the date of Salad House's sale on October 31, 1968, Mr. Brams put in fewer hours at Salad House than had been his custom, and Popkin assumed correspondingly more control of the day-to-day operation of the business.

Popkin's elevation coincided with the onset of Mr. Brams' ill-health. Mr. Brams developed severe chest discomfort, and saw a doctor for diagnosis and treatment at least as early as

March 1968. Although the initial diagnosis was that Mr. Brams suffered from a hiatus hernia, it was determined in April of 1969 that he had been suffering from arteriolosclerotic heart disease with angina. During this same period from late 1967 through October 1968, Mr. Brams often was depressed and found it increasingly difficult to deal effectively with the daily Salad House routine.

Also at this time, Mr. Brams began negotiating through Popkin with one Matthew G. Matteosian (Matteosian), president and a substantial shareholder of G. D. Mathews & Sons, Inc. (the buyer), for the sale of Salad House. In November of 1967, Mr. Brams rejected an offer of between $300,000 and $330,000. However, on October 31, 1968, a sale was agreed to by the parties with a total purchase price of $360,000. The buyer did not know of Mr. Brams' ill health at this time.

Mr. Brams decided upon the minimum price he would accept by determining the amount of money he would require to live comfortably in

retirement. Thr price offered by the buyer was determined by lawyers and accountants for the buyer to be the fair worth of Salad House. Although Mr. Brams attended almost every negotiation session, the primary negotiator for Salad House was Popkin. Further, Mr. Brams relied upon Popkin's representations that the sale contract was favorable (including the tax consequences) to him.

The sale contract is extremely detailed and specifically allocates $80,000 of the purchase price to the name "Salad House, Inc." and its accompanying goodwill, $130,000 to the remaining assets of Salad House, and $150,000 to a covenant by petitioners payable in installments only to Mr. Brams and obligating each of the petitioners and Robert not to directly or indirectly engage, or become interested, in the manufacture or sale of specified food products in the New England area for a period of 10 years. Neither Mrs. Brams nor Robert received anything in exchange for their signing the covenant. Neither Mr.

Brams nor Matteosian broke down (in his own mind) the purchase price into specific amounts for goodwill, tangible assets, and the noncompetition agreement.

The buyer never employed anyone to verify that petitioners and Robert were satisfying the terms of the covenant. However, it was common knowledge among those in the trade that petitioners were vacationing in Florida. In addition, Robert once desired to manufacture certain of the products listed in the covenant not to compete, and he asked Matteosian for permission to do so. That permission was refused.

OPINION

This case is another in a long line where the issue is whether a party to an agreement involving the sale of a business should be bound by an allocation made in the agreement of sale to a covenant not to compete. Resolution of the issue will determine whether the payments received by Mr. Brams in respect of the covenant should be treated as ordinary income, as respondent contends, or should be

attributable to the sale of the assets of the business (particularly its good will) and treated as long-term capital gain, as petitioners contend. Respondent has not sought herein to apply the so-called "mistake, undue influence, fraud, duress, etc." rule of Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967), presumably because this Court has not adopted that rule and continues to adhere to the so-called "strong proof" standard--a standard which also prevails in the Fifth Circuit Court of Appeals to which an appeal in this case would lie. See Sonnleitner v. Commissioner, 598 F.2d 464, 467 (5th Cir. 1979); Buffalo Tool & Die Mfg. Co. v. Commissioner, 74 T.C. 441, 446 n. 9 (1980).

The "strong proof" rule has been the subject of divergent views among the courts in respect of whether it rests on the intention of the parties, "economic reality," or a combination thereof. See Lazisky v. Commissioner, 72 T.C. 495, 501-502 (1979). Cf. Dixie Finance Co. v. United States, 474 F.2d 501, 505 (5th

Cir. 1973). We find it unnecessary to probe the nuances of the difference between, or overlap of, the aforesaid two prongs of the rule, since we conclude that the petitioners, who have the burden of proof (Wager v. Commissioner, 52 T.C. 416, 418 (1969); see also Buffalo Tool & Die Mfg. Co. v. Commissioner, supra at 446), have failed to carry their burden whichever prong is applied. See O'Dell v. Commissioner, 61 T.C. 461, 467, n. 5 (1974). In passing, we note, however, that this Court has indicated a preference for the "economic reality" prong. See Lazisky v. Commissioner, supra at 501.

As to the parties' intent, we are not persuaded that they did not intend to make the allocation set forth in the agreement. An examination of the agreement for the sale of the Salad House business shows that it was very carefully tailored to cover every element of the transaction and petitioners have not demonstrated that the allocation was inserted only after the negotiations had been completed and

the terms agreed upon. Cf. Howard Construction, Inc. v. Commissioner, 43 T.C. 343, 355-356 (1964). To be sure, there was some testimony which indicates that Mr. Brams may not have considered the covenant not to compete of any importance or may not have fully understood its tax implications. But the record clearly shows that he participated in most of the negotiating sessions, that he read the agreement before he signed it, and that its terms were explained to him. Moreover, although Matteosian's testimony has some overtones of lack of concern over the possibility of competition, he repeatedly testified that he understood that the agreement contained the covenant and that he relied upon it. Moreover, we think it significant that Matteosian refused Robert's request to be released from his obligation not to compete. Thus, it cannot be said that the buyer did not value the covenant. Cf. Wager v. Commissioner, supra at 419. Under the foregoing circumstances, we cannot say that petitioners have offered the requisite "strong proof" that the

terms of the agreement did not comport with the intention of the parties.

As to "economic reality," we are satisfied that Mr. Brams' illness should not be elevated to the level of "strong proof" that the covenant did not have substantive meaning. In the first place, the buyer was not aware that Mr. Brams was ill at the time the agreement was consumated. Indeed, his illness was not diagnosed until more than one year after the sale of the business. Second, there are clear indications that, even taking his illness into account, Mr. Brams could have used his knowledge (both technical know-how and business acumen) to join forces with others in order to enter into competition. The fact that he might not have been able to work as hard as he had in the past and that others might have had to carry the laboring oar of day-to-day operations of the competing business is not enough to provide a "strong proof" foundation based upon Mr. Brams' illness. Moreover the covenant bound Mrs. Brams and Robert as well as Mr.

Brams, and there was no evidence establishing their inability to compete. See pp. 11-12, infra.

We similarily reject petitioners' attempt to analyze the financial aspects of the business in order to show that the other elements of that business, i.e., the net assets and goodwill, were of such great value as to absorb most, if not all, of the total amount paid in respect of the covenant not to compete, with the result that the covenant should not be accorded any value. The evidence of record simply does not support such analysis. The amount allocated ($150,000 of a total sale price of $360,000) was not so excessive as to undermine its own credibility. Cf. Levine v. Commissioner, 324 F.2d 298 (3d Cir. 1963), affg. a Memorandum Opinion of this Court; Levinson v. Commissioner, 45 T.C. 380 (1966).

In short, we conclude that petitioners have not carried their burden of proof in respect of "economic reality."

Petitioners' reliance on Dixie Finance Co.

v. United States, supra, is totally misplaced. In that case, the Court of Appeals refused to set aside the original allocation to a covenant not to compete despite a subsequent written modification thereof, stating that there was insufficient evidence under the "strong proof" rule to justify relieving the parties from the tax consequences of the original allocation. See 474 F.2d at 505. If anything, that case would appear to support respondent's position herein; in any event, it is clearly distinguishable.

Petitioners further argue that, because "the covenant not to compete was so broad as to encompass persons who had no interest in the stock of Salad House, Inc., and were not active in the management of the business," it is invalid as repugnant to the public policy of Massachusetts. There are several problems with petitioners' position. First, Mrs. Brams and Robert were active participants in the business, and the fact that they received no payment for their agreement has no significance.[1]

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[1] Petitioners make no argument that a portion of the payments to Mr. Brams should be allocated to Robert and taxable to him.

Second, it is clear to us that, under Massachusetts law, the covenant not to compete is reasonable because it accorded the buyer the amount of protection it reasonably needed. Marine Contractors Co., Inc. v. Hurly, 365 Mass. 280, 310 N.E. 2d 915, 920 (1974); Marshall Engine Co. v. New Marshall Engine Co., 203 Mass. 410, 89 N.E. 548 (1909).[2] We think it highly likely that both Mrs. Brams and Robert could have utilized their knowledge of the Salad House business to have been able to compete with the buyer. Cf. Slate Co. v. Bikash, 343 Mass. 172, 177 N.E. 2d 780 (1961). Finally, even if the covenant not to compete were invalid under Massachusetts law, such invalidity would not change the character of the amounts received in respect

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[2] Neither party furnished us with any analysis of Massachusetts law. Petitioners cite in support of their contention only Domurat v. Mazzaccoli, 138 Conn. 327, 84 A.2d 271 (1951). Yet, as petitioners recognize, that case explicitly excludes from its condemnation all noncompetition agreements which are ancillary to the sale of a business and reasonably designed to protect the buyer. It is therefore clearly distinguishable.

thereof nor their taxability to Mr. Brams.[3] Cf. Patterson v. Anderson, 20 F. Supp. 799, 801 (S.D.N.Y. 1937); see Rutkin v. United States, 343 U.S. 130, 137 n. 8 (1952); Shaw III v. Commissioner, 59 T.C. 375, 382 (1972).

Petitioners' last argument is that they should not be bound by their contractual allocation because Popkin, who negotiated the contract on their behalf, so petitioners allege, was unfaithful and perhaps even dishonest. Even if established, such facts would not undermine the Commissioner's determination; if any relief is appropriate, it can only be obtained in some other forum.

Decision will be entered for the respondent.

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[3] Certainly, to the extent that the intent of the parties is the test of allocability, invalidity of the agreement would have no effect. Cf. Perlmutter v. Commissioner, 45 T.C. 311, 317 (1965). In terms of "economic reality," petitioners were paid for covenant they gave and implemented so that the substantive nature of the payments are clear, irrespective of the legal force of the agreement.

APPENDIX C

S. 80-871 Appeals Court

THEODORE R. ADAMS vs. YELLOW CAB CORPORATION OF BOSTON & BROOKLINE.
September 3, 1981.

In this suit for personal injuries sustained while the plaintiff was in a taxicab, the defendant sought to defend on the ground that there was no evidence that the cab belonged to it. The defendant appeals from a judgment after a jury verdict for the plaintiff.

We are constrained to reverse. An examination of the record as a whole shows that the trial judge did not fulfill his role as an impartial magistrate. His repeated jibes at defense counsel held the latter up to scorn and ridicule and could not have failed to leave the jury with the impression that the plaintiff should prevail. Such conduct is subject to serious criticism and warrants a new trial. Federal Natl. Bank v. O'Keefe, 267 Mass. 75, 83 (1929). Ott v. Board of Registration in Medicine, 276 Mass. 566, 574 (1931). Clapp v. Haynes, Mass. App. Ct. (1980).[a] See Olson v.

[a] Mass. App. Ct. Adv. Sh. (1980) 2244.

Ela, Mass. App. Ct. , (1979);[b] Gauntlett v. Medical Parameters, Inc., Mass. App. Ct. , (1980).[c]

The most egregious episode occurred at the beginning of the trial when defense counsel, after objecting to the admission of certain records of the hackney division of the Boston Police Department, asked, "May I be heard at the bench?"

THE COURT: "No, no, no, no, no, no. What do you want to hide from the jury?"

COUNSEL: "Pardon me?"

THE COURT: "What do you want to hide from the jury?"

COUNSEL: "Judge, with all due respect to the Court, I didn't say I wanted to hide anything from the jury."

THE COURT: "Well, why do you want to see me at the bench?"

It should be obvious that when counsel follows the correct method of voicing an objection

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[b] Mass. App. Ct. Adv. Sh. (1979) 1570, 1573.

[c] Mass. App. Ct. Adv. Sh. (1980) 1185, 1191.

and seeks to approach the bench to state his grounds, see Mass. R. Civ. P. 46, 365 Mass. 811 (1974), the judge should not suggest that counsel is trying to keep the facts from being presented to the jury. See Etzel v. Rosenbloom, 83 Cal. 2d 758, 762 (1948); Allen v. Kidd, 197 Mass. 256 (1908) (improper intimation that plaintiff was stubborn and brought suit for spite).

The record is replete with other inappropriate judicial comments. For example, the judge indicated to defense counsel that he did not want to hear matters at the bench unless "awfully prejudicial", saying, "I hope you're right that it is prejudicial, because I hate getting up and walking." When plaintiff's counsel objected to a question of defense counsel, the judge ruled, "sustained", adding derisively, "What the little boy told the little girl told the little boy told the little girl told her is not evidence here." On another occasion, the judge invited the plaintiff's counsel

to object and when the objection was made, again repeated, "All right. I'll sustain the objection. What the little boy told the little girl told the little boy told the little girl . . . ."

These intemperate remarks, objected to by counsel, were not made the subject of a special curative instruction, compare Olson v. Ela, Mass. App. Ct. at ,[d] and were not harmless. They not only impermissibly invaded the integrity of the jury's fact finding function by indicating the views of the trial judge, but they seriously hampered defense counsel in presenting his case. We need not resolve whether counsel's efforts on cross-examination were in proper form as we consider the failures by counsel to be due in large part to his being harassed by the judge. Needless to say, the judge's function is not to render counsel ineffective.[e]

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[d] Mass. App. Ct. Adv. Sh. (1979) at 1574.

[e] Emphasis and underscoring added by counsel for Petitioners.

We do not consider other issues as they are unlikely to recur at a new trial.

Judgment reversed.

John C. Ottenberg for the defendant.
Richard B. Parker for the plaintiff.

Suffolk. June 9, 1981.--September 3, 1981.

Present: Perretta, Dreben, & Kass, JJ.

Opposition

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No. 81-786

In the Supreme Court of the United States

OCTOBER TERM, 1981

NATHANIEL BRAMS AND EIREEN BRAMS,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioners seek review of the decision below in this federal income tax case that a payment they received pursuant to a written sales agreement was for a covenant not to compete, and therefore taxable as ordinary income, and not for the sale of a business, which would be taxable as capital gain.

The pertinent facts may be summarized as follows: Petitioner Nathaniel Brams founded Salad House, Inc., a producer of commercial salads, in 1955. His wife, Eireen Brams, was an employee of Salad House from its founding and worked with her husband in the business. Their son, Robert Brams, also worked in the business. Beginning in 1967, Nathaniel Brams, due to ill health, delegated substantial managerial responsibility to Milton Popkin, a longtime employee of Salad House. Through Popkin, Brams began

negotiating for the sale of Salad House to G.D. Mathews & Sons, Inc., which was substantially owned by Matthew G. Matteosian. The buyer was not aware of Brams' ill health (Pet. App. 23-24).

On October 31, 1968, the parties agreed to a sale of Salad House for the sum of $360,000. The sales contract specifically allocated $80,000 to the name "Salad House, Inc.," and its accompanying goodwill; $130,000 to the remaining assets of Salad House; and $150,000 to a covenant not to compete, payable in installments only to Nathaniel Brams, although the covenant also barred Brams' wife and son from competing. G.D. Mathews & Sons did not monitor petitioner's activities to insure his compliance with the covenant not to compete, but it was apparently well known in the area that Nathaniel and Eireen were then residing in Florida. G.D. Mathews & Sons on one occasion did deny permission to Robert to compete in certain lines covered by the covenant (Pet. App. 24-25).

Petitioner received monthly payments for the covenant, which he treated as ordinary income. In 1973, the taxable year in question, he received a lump sum payment for the remaining amount due for the covenant not to compete (Pet. 3-4). Petitioners reported that payment as capital gain. On audit, the Commissioner of Internal Revenue determined that the payment was ordinary income. In this proceeding brought by petitioners for redetermination of the resulting deficiencies, the Tax Court upheld the Commissioner's determination (Pet. App. 21-34) and the court of appeals affirmed (Pet. App. 20).

1. The decision below correctly held that the 1973 payment was for the covenant not to compete, and has therefore taxable as ordinary income. Payments made pursuant to a covenant not to compete are taxable as ordinary income to the seller, and deductible by the buyer. Conversely, payments for goodwill give rise to capital gain to the

seller, and are not deductible by the buyer. Thus, the buyer and seller of a business ordinarily have adverse tax interests. See, *e.g.*, *Ullman* v. *Commissioner*, 264 F. 2d 305 (2d Cir. 1959).

Where, as here, one party to the written agreement seeks to disavow an allocation to a covenant not to compete, the courts have permitted that disavowal only under limited circumstances. In some circuits, the taxpayer is required to show by "strong proof" that the written allocation was not intended or lacked economic reality. See, *e.g.*, *Sonnleitner* v. *Commissioner*, 598 F. 2d 464 (5th Cir. 1979); *General Insurance Agency, Inc.* v. *Commissioner*, 401 F. 2d 324, 327 (4th Cir. 1968); *Barran* v. *Commissioner*, 334 F. 2d 58 (5th Cir. 1964); *Schulz* v. *Commissioner*, 294 F. 2d 52 (9th Cir. 1961). Other courts, however, have adhered to the view that a written allocation may not be disregarded, absent a showing that the allocation was due to fraud, duress or undue influence. See, *Commissioner* v. *Danielson*, 378 F. 2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967). Accord: *Proulx* v. *Commissioner*, 594 F. 2d 832 (Ct. Cl. 1979); *Spector* v. *Commissioner*, 641 F. 2d 376 (5th Cir. 1981).

Here, the Tax Court applied the "strong proof" rule and found that petitioners had failed to make the requisite showing that the agreement was not intended or that it lacked economic reality (Pet. App. 28-31).[1] The court of

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[1]The Tax Court, under its decision in *Golsen* v. *Commissioner*, 54 T.C. 742 (1970), applied the law of the Fifth Circuit, because it then appeared that proper venue would be in that circuit. At the request of petitioners, however, the parties subsequently stipulated to appellate venue in the First Circuit.

At the time of the Tax Court's decision, the Fifth Circuit generally adhered to the "strong proof" rule. See *Sonnleitner* v. *Commissioner*, *supra*; *Barran* v. *Commissioner*, *supra*. Subsequently, the Fifth Circuit adopted the *Danielson* rule, albeit not in a case involving a covenant not to compete. See *Spector* v. *Commissioner*, *supra*, 641 F. 2d at 376.

appeals relied on its own precedent in *Harvey Radio Laboratories, Inc.* v. *Commissioner*, 470 F. 2d 118 (1st Cir. 1972). There, the court held that where the parties to a sale of a business have allocated a portion of the payment to a covenant not to compete, they will not be permitted to disregard that agreement for tax purposes. Although the court declined to adopt the *Danielson* rule, as the government had urged, it rejected a test which looked to the "economic reality" of the transaction, and instead stated a rule which places a substantially higher burden of proof on a taxpayer seeking to disavow a written allocation to a covenant not to compete than required by the "strong proof" rule.

In seeking review, petitioners argue that the decision below conflicts with decisions of other courts of appeals that have adopted the "strong proof" rule. It is clear here, however, that regardless of which standard of proof is applied, petitioners cannot prevail. Indeed, the Tax Court applied the "strong proof" rule and found on this record, that there was no basis for disregarding the written allocation in the sales agreement (Pet. App. 28-31).

The thrust of petitioners' argument is that the covenant was meaningless because Nathaniel Brams' ill health prevented him from competing, and he did not intend to make the covenant. But the record is to the contrary. Brams participated in the negotiations, had the terms of the contract explained to him, and read it before signing (Pet. App. 29). As for his ill health, both Brams and his physician testified that he was capable of running the business when it was sold. Furthermore, as the Tax Court found, Brams conceded that the most valuable asset he conveyed in the sale was his know-how, which he could have used to start a competing business. Nor was the amount of the allocation so excessive as to be devoid of reality (Pet. App. 30-31). Thus, since petitioner cannot prevail under either the

"strong proof" rule or the *Danielson* rule, this case is not an appropriate vehicle to resolve whatever conflict may exist among the courts of appeals with respect to the degree of proof necessary to disregard a contractual covenant not to compete.[2]

2. Finally, petitioners' contention (Pet. 15-18) that the Tax Court interfered with the presentation of their case is without merit. As petitioners concede (Pet. 15), the judge has substantial discretion in the conduct of a non-jury trial. Here, petitioners' complaints about the conduct of the trial judge were reviewed by the court of appeals and the conduct of the Tax Court judge was found to be non-prejudicial (Pet. App. 20). There is no basis for further review of this finding.[3]

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[2] *Dixie Finance Co.* v. *United States*, 474 F. 2d 501 (5th Cir. 1973), upon which petitioners rely (Pet. 10-11), is distinguishable. There, noncompetition payments were distributed to the shareholders pro rata, no additional consideration was given to those most able to compete, and there was no effort to monitor the agreement. Moreover, of a total sales price of $650,000, $526,150 was allocated to the covenant not to compete. On these particularlized facts, the court concluded that no portion of the sales price should be allocated to the covenant not to compete. Here, on the other hand, less than half of the $360,000 purchase price was allocated to the covenant not to compete, the parties bargained as to the covenant, and the record showed that Brams was fully capable of conducting a rival business.

[3] In the court below, petitioners complained that the Tax Court abused its discretion in restricting some of their counsel's cross-examination of witnesses. However, all of the witnesses were called by petitioners, and counsel did not cross-examine any of them, or seek to have them called as hostile witnesses so as to permit cross-examination. The Tax Court's limiting of petitioners' counsel from asking leading question was accordingly proper.

Beyond that, petitioners complained of the manner in which the Tax Court questioned one of their witnesses. A fair reading of the pertinent colloquy (A. 260), however, in no manner supports their claim that the Tax Court suggested the correct answer to the witness. Lastly, petitioners complained of a colloquy (A. 261) occurring after objection by

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

DECEMBER 1981

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counsel for the Commissioner to repetitive questioning by petitioners' counsel. The Tax Court's admonition to petitioners' counsel was well taken in view of his repeated attempts to ask the same question when the first response was not the response that he hoped to elicit.

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